FINANCIAL ECONOMIST ROUNDTABLE

For release
December 22, 2004

STATEMENT ON “CORPORATE PENSION FUND ACCOUNTING”

The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

The following statement on “Corporate Pension Fund Accounting” is the result of a discussion at FER’s annual meeting on July 11-12, 2004 in Niagara-on-the-Lake, Canada. A list of members approving the statement and their current or most recent affiliation is attached.

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Statement of the Financial Economists Roundtable

On

Corporate Pension Fund Accounting

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The Financial Economists Roundtable (FER) discussed the current problems in accounting for corporate pensions at its annual meeting in 2004 and issued the following statement that details the problems and identifies potential solutions.

Executive Summary

1. **Discount rate for liabilities**: The Pension Fund Equity Act permits companies to increase the discount rates used for valuing their pension liabilities, thereby allowing them to understate the amounts for which they actually are liable. The FER condemns this imprudent legislative change, and recommends a return to valuing liabilities using a discount rate based on U.S. Treasury interest rates.

2. **Funding of PBGC guarantees**: The FER is dismayed by the increase in the potential liabilities of the Pension Benefits Guaranty Corporation (PBGC), partly as a consequence of the Pension Fund Equity Act. The PBGC guarantees a minimum pension for retirees, and is funded by premiums paid by companies with defined benefit obligations. The current premiums do not adequately reflect the risk that insured firms will default on their pension obligations. As a result, the PBGC will likely have insufficient funds to pay promised obligations and will have to seek funds from the US Treasury, which is ultimately underwritten by the taxpayer. The FER recommends that plan sponsors be charged a sufficient high penalty rate for underfunded plans so as to cover the PBGC's expected

obligations and encourage management of underfunded firms to take stronger measures to bring themselves to a fully funded status.

3. **Valuation of assets**: The FER is concerned that pension funds may be invested in illiquid assets whose market values are below their reported values. The market values of assets that are illiquid (such as real estate and corporate debt and stock that are not regularly traded in arm's length transactions) often cannot be readily determined or effectively audited. Therefore, the FER recommends that pension assets should be invested overwhelmingly in marketable securities, that they should be reported at currently realizable market values, and that there should be strict guidelines as to how illiquid assets may be valued.

4. **Smoothing (averaging) of deficits**: The FER regards the practice of smoothing deficits over multiple years as potentially dangerous. At times, this creates the illusion of improvement for plans whose position is in fact worsening. The FER recommends that assets and estimated liabilities be reported no less frequently than quarterly, and based on current market values of assets and the appropriate discount rate applied to liabilities. A full actuarial analysis of liabilities may be updated on an annual basis.

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I. Introduction

The business and daily press increasingly are reporting that the defined-benefit pension plans of many corporations are underwater. These plans promise employees monthly pensions after they retire, usually based on their earnings in their last years of employment multiplied by the number of years they were employed. In 2003 and 2004, company pension plans were underfunded by nearly $400 billion. In 2000 and 2001 the underfunding was less than $40 billion.*

Will there be enough money to pay those promised pensions? This question has become particularly important to employees and retirees of companies that have experienced or are at risk of bankruptcy. If a company with an underfunded pension plan experiences severe financial distress, such that it is likely to shutdown if it had to fully fund its plan, the Pension Benefits Guaranty Corporation (PBGC) would take over the plan and guarantee pension payments up to a maximum amount (in 2004, $3,700 per month for workers who retire at age 65). The PBGC then becomes a general creditor of the bankrupt sponsor and has a priority claim against the sponsor's assets for contributions that accrued within 180 days prior to the bankruptcy filling. Claims on behalf of employees with pension claims exceeding the PBGC maximum are pursued by PBGC as plan trustee. The plan is a general unsecured creditor of the sponsor. These claims are unlikely to be fully met, considering both that the plan was underfunded and that the stated

* See *Business Week*, "The Benefits Trap" by Nannette Byrnes, 19 July 2004, 64-71.

amount of the underfunding might have been substantially understated. For example, only 84% of Bethlehem Steel's reported pension liability of $4.3 billion was covered by the PBGC. Coverage for LTV Steel and National Steel was similar (84% and 81%). Furthermore, when the PBGC took over Bethlehem Steel's pension plan, it learned that only 45 percent of its plan's pension liability was actually funded. Therefore, employees have reason to be concerned about the extent to which their companies have really put away enough to meet pension obligations.

An important issue is whether the PBGC will be able to meet its guarantees. As of its year-end, September 2003, the PBGC reported a deficit of over $11 billion. This deficit is a result of its having had to assume liabilities for pensions of $45 billion from bankrupt companies. The largest of these has been Bethlehem Steel, which terminated its plan in 2003. The PBGC assumed the pensions for some 97,000 participants with claims of $3.65 billion. If the PBGC cannot increase the premiums it charges sufficiently or earn enough on its assets, and if it must assume even greater liabilities, it is likely that the shortfall will have to come from taxpayers, as happened in the S&L crisis when the Federal Savings and Loan Insurance Corporation (FSLIC) went bankrupt.

The Financial Economists Roundtable (FER) recommends several actions to minimize the deficit of the PBGC, increase the security of pensioners, and reduce the likelihood of a bailout of the PBGC by the US Treasury and ultimately the taxpayer. First we consider the appropriate discount rate used to discount pension liabilities and then the inadequacies of the current method of funding the PGBC. We then consider the valuation of plan assets and the timely reporting of assets and liabilities of the plan. All our recommendations are designed to lead to a more transparent and better-funded plan that minimizes risks to employees and taxpayers.

II. Company Pension Liabilities That Should Be Reported to Employees

A company's pension liability is based on (1) the amount promised to employees when they retire; (2) an estimate of which employees will stay with the company long enough to get pensions; (3) an estimate of how long pensions will be paid to retirees and their spouses; and (4) a discount rate to bring these amounts to the present. As financial economists, we are concerned with the appropriate discount rate.

The PBGC specifies that actuaries must use a discount rate no greater than 105% of the four-year weighted average of the 30-year US Treasury bond yield. The 30-year Treasury rate (or the equivalent, since these Government obligations are no longer issued) presently is low relative to prior years. The Administration and Congress have responded by enacting the Pension Funding Equity Act of 2004 (which covers 2004 and 2005). All companies with defined benefit plans may now use 90% to 100% of a long-term high-quality corporate bond rate. For 2004, the applicable range now is 5.89% to 6.55%, compared to the prior range of 4.72% to 5.51%. Through the magic of government fiat, reported pension liabilities shrink by roughly 20%..

We object to this change for two reasons. First, it necessarily will understate pension liabilities. Second, the appropriate discount rate should not be set politically, as this runs the risk of a hidden subsidy to some companies and taxpayers, the cost of which will be borne by others. Rather, we believe that the correct rate for measuring a company's promised obligation to its employees is the pre-tax rate on risk-free obligations with approximately the same average maturity as the pension liability. Any higher rate would require pension funds to take the risk of assets being insufficient to pay the promised pensions.

III. Pension Assets – What Should be Reported to Employees and to the PBGC?

Pensions are funded with assets transferred from companies to separate legal entities that are tax exempt. Employees' pension claims would not be at risk if companies were required to fully fund their pension liabilities with matching risk-free assets. However, companies actually invest pension funds in risky assets. If the assets increase in value, the fund sponsors can reduce their future payments. If they decline substantially, though, the sponsors may not be able to make up the shortfall and it may have to be fulfilled by the PBGC if the sponsor declares bankruptcy.

Although a good case could be made for requiring pension funds to be invested in assets whose characteristics match their pension liabilities, this is too draconian a change. At the least, pension fund assets should be those that can be valued by reference to arm's-length-determined market prices or the equivalent. Although the market price of such assets might decrease substantially, at least the shortfalls will not be due to accidental or deliberate overvaluations. Overvaluations might occur because corporate officers are overoptimistic or because the values of some assets, such as real property, cannot be determined accurately until they are sold. In addition, opportunistic and dishonest sponsors may invest in overpriced pension assets, such as the untraded securities of related companies or property previously owned by corporate insiders or related parties.

The Financial Economists Roundtable recommends that pension assets must be invested overwhelmingly in marketable securities that can be valued with relevant, reliable, and verifiable actual market prices, and that infrequently traded assets be valued at realizable values. Registered Public Accountants (usually CPAs) should attest to the validity of these valuations.

Asset values should be restated at least quarterly and reported to employees and to the PBGC, together with the amount of the pension liability.

IV. PBGC's Obligations

The Pension Funding Equity Act of 2004 has exacerbated the PBGC's deficit. In addition to raising the allowable discount rate for computing pension obligations, thereby understating those liabilities, Congress made the change retroactive to 2003. Under this act fully funded plans generally did not have to contribute to their pension funds in 2004. The Act also exempts underfunded plans in the commercial airline and steel industries from paying in 2004 and 2005 all but one-fifth of the expedited contributions that are required when a plan is less than 90% funded. Exempting weak industries from funding requirements increases the chance that PBGC will run increasing deficits.

The Financial Economists Roundtable believes that the PBGC should not be allowed to continue to run a deficit, and that plan sponsors should not be able to continue to underfund pension plans over lengthy periods of time. Forbearance of company funding requirements is likely to result in a greater burden on compliant companies and taxpayers, similar to the unfortunate experience with savings and loan associations in the 1980s.

In some cases, requiring corporations to meet their obligations to the PBGC may cause a company to declare bankruptcy. Nevertheless, the possibility of bankruptcy is preferable to forbearance, for two main reasons. First, it allows such corporations to restructure their obligations so that they can return to normal operations; and the cost of the restructuring should be borne by all creditors, including employees whose promised pensions exceed the PBGC guarantee. Second, forbearance gives companies an incentive to put off having to deal effectively with disproportionate pensions obligations. The net result is that the costs are likely to be passed on to companies that meet their obligations and (to the extent of any Congressional bail-out) to taxpayers.

We recommend that the PBGC both assess a sufficiently high penalty fee for companies with pension funds that are inadequate to cover their accumulated benefit obligations (correctly measured, as we outlined earlier) and expeditiously monitor underfunding. PBGC now assesses a fee of $9 per $1000 of underfunded liability. However, Richard Ippolito, former chief economist of the PBGC, calculates that it has collected only $0.50 per $1000.[**] It is no wonder that many companies have not made required payments for years, thereby substantially increasing the amount that will have to be made up by companies that meet their obligations and possibly by taxpayers. It is clear that both the penalty rate and its effective administration by the PBGC should be increased to provide strong incentives for companies to fund their plans fully.

The actuarial analysis of a company's pension liability need not be re-estimated more often than annually, unless there is a substantial change in the key assumptions. However, the present value of those obligations can readily be computed, and these estimates should be made at least quarterly, to accompany the valuations of pension assets. With valuations that are at least quarterly, there is no role for smoothing of deficits. The Financial Economists Roundtable recommends that the funding position of pension plans should always be assessed from current – not smoothed – market values.

The changes we recommend will provide more accurate information to policy-makers and corporate decision makers, as well as to those whose retirement income is at risk.

[**] Richard A. Ippolito, "How to Reduce the Cost of Federal Pension Insurance," *Policy Analysis*, No. 523, CATO Institute, August 24, 2004. He recommends conversion of the PBGC into mandatory self-insurance pools whose members are jointly liable for deficits.

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